October 3, 2007

INVESTMENT POLICY MEMO

Even before our last Investment Memo reached most of you, we were turning in a more cautious direction. The Federal Reserve Bank and its European and British counterparts, performed exactly as we had forecast almost immediately after our August 14th Memo. However we are now more concerned about the possibility that the U.S. housing debacle and the weirdly opaque and troubled one trillion dollar U.S. asset-backed commercial paper market may not respond to reductions in the Federal Funds rate or injections of liquidity into the banking system.

We still believe that the chances of an outright recession are somewhere between one in ten and one in five. However, we now think such a recession would be very severe. Furthermore, we think there is better than a fifty percent chance of at least a "virtual recession" with economic growth over the next year at about one percent and with at least one calendar quarter of declining GDP -- essentially the 2001 recession, which roiled Wall Street more than Main Street. At the same time stock markets in the U.S. and much of the world have recently gone to new all time highs. At similar levels in July, we thought prices were too high and we think so again.

We are in a time of extreme uncertainty and bizarre anachronisms. There is a good case to be made that the implosion of the American house price bubble and ill-considered mortgage financing will lead to a severe recession in the U.S. and much of the world. There is also a good chance that the actions of central banks in Europe, Japan and America, coupled with the strong growth of the emerging economies will mitigate the effects of the housing and mortgage implosions enough to cause continued modest positive growth in all of these regions.

Things have happened in the last three months that never happened before in my lifetime: banks refusing to lend to each other for more than a few days or refusing to lend to each other at all; some one to two trillion dollars of short term obligations that nobody felt able to accurately price; a consequent breach of redemption rights by hedge funds and even more disturbingly by virtual money market funds; depositors lined up to take their money out of a bank because they feared it might fail. This is the stuff I used to teach my economic history students about the Great Depression and the wild and wooly financial markets of the Nineteenth Century.

It is far from certain that these disruptions have already run their course. And even if they have, it is very likely that they will have more substantial impact on the economies of Europe, Japan and America than we have seen so far, particularly because of the interaction of more constrained mortgage lending with a glut of houses for sale by builders, speculators, banks that have foreclosed on mortgaged property, and the usual number of people selling for more ordinary reasons.

The only unambiguously positive story at the moment is the uninterrupted progress of emerging countries like China, India, Indonesia, Brazil and Mexico. In all these economies a rapidly expanding class of better-paid workers and professionals is creating an internal consumer

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market that collectively already rivals total U.S. consumption and is destined to far exceed it. A closer look at recent stock market strength reveals a growing respect for these trends. In the past three months the stock markets in these emerging countries have gained between 20% and 50%, as much as might normally occur in three years. Meanwhile the comparatively modest rebounds in the U.S. and other developed country stock markets have been concentrated in companies with the most exposure to emerging markets and/or businesses that will hold up best if growth in the developed countries slows down.

These same emerging market developments raise another serious question: Is inflation really dead? The rapid growth of employment in industry and urban services in the emerging countries is now reflected in a very rapid rise in wages. Since benign inflation in the advanced countries has been importantly supported by low wages in the emerging countries, this development could signal an imminent end to the disinflationary benefits of globalization. In addition, as the number of urban food consumers increases at the expense of rural food providers and cultivated land, most emerging markets are experiencing inflation in food prices, which is already evident in the developed countries as well, compounded by the effects of ethanol production from food crops. This comes on top of the inflationary effect that growth in emerging countries has had on most industrial commodities and fuels.

Possibly these inflationary developments will turn out to be early warning signs of an increase in global inflation three or four years from now. However, yet another distinct specter on the horizon continues to be the possibility of a U.S. or Israeli attack on Iran or some other act of war or terrorism that could disrupt significant flows of petroleum and accelerate military and 'security' spending. In that event the balance might be tipped toward increasing inflation immediately.

Before and since our last Memo we have kept substantial amounts of client investments in bonds and cash. These holdings were a necessary insurance policy, although to this moment they have not been particularly helpful. Even so, our portfolios have performed quite well because of an emphasis on information and telecommunications technology, consumer staples and healthcare and a corresponding avoidance of financial stocks. Our portfolios have also benefited strongly from stocks selected to benefit from a declining dollar and from investments in alternative energy and emerging market countries.

The economies of developed countries, like their stock markets, are acting more like the end of something than the beginning. Consumer expenditures on durables and housing continue to decline. Confidence among consumers and businesses is also weakening. Business capital spending remains surprisingly tame outside of telecommunications, information technology and biopharmaceutical production. Productivity growth has become anemic and unit labor costs are rising faster than inflation. Current forecasts for profit growth over the next year or two look overly optimistic; but we have said this before and been wrong. Nevertheless, we think now is a time to sell additional stocks in developed countries, especially those most sensitive to the business cycle, using the proceeds to increase cash and bonds.